Exchange rate targeting in New Member States of the European Union: New Times, New Challenges

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Abstract. This article points out some of the challenges of the monetary authorities in countries which have fixed exchange rate arrangement. In the current crisis environment, the Baltic States and Bulgaria seem to have more problems than solutions. Though, the situation is not very appealing now and in the future, they could exploit the status of being pegged to euro, by adhering sooner to the euro zone than the Visegrad Group if they urgently correct the financial-budgetary and external imbalances.

Key words: monetary policy, crisis, exchange rate arrangement, convergence, inflation

1 Introduction

In general, national policies represent useful tools for modelling the (nominal) convergence process, especially monetary policies which are solid adjustment instruments for the management of the most important macroeconomic imbalances (e.g. inflation, exchange rate volatility). In this article we will focus on a concrete analysis of the Baltic States and Bulgaria's environment in which monetary policies operate and the main problems faced by the monetary policies of these countries in pursuit of the nominal convergence criteria.

As it is known, among the motivations underlying the exchange rate targeting in the Baltic States and Bulgaria are: the high degree of openness of the economies and the small size of the Baltic countries. Both require the choice of the exchange rate as a nominal target in monetary policy, using a strong currency as anchor (e.g. deutsche mark, US dollar, recently euro) to reduce inflation and inflation expectations (anchoring the internal inflation of the external one).

Under fixed exchange rate arrangement, the convergence of prices during the catching up process can only take place through higher inflation in the New Member States (NMS). This idea is sustained by the highest inflation rates during the 12-month period ending in April 2008 recorded by the three countries pegging their currencies to the euro under currency board arrangement (Bulgaria, Estonia, and Lithuania) and by Latvia, which maintains a conventional peg to the euro.

Besides the higher inflation associated with the real convergence process, there have been other factors that have contributed to inflationary pressures in the Central and East European (CEE) countries with fixed exchange rate. As long as the confidence in the sustainability of the fixed exchange rate remains strong, domestic nominal interest rates tend to be at or close to euro interest rates. Since the convergence effect pushed the inflation rate in the CEE countries with fixed exchange rate above the inflation rate in the euro area, the domestic real interests have become very low or negative. This has led to credit booms and overheating, putting further upward pressures on prices. In these circumstances, interest rates have actually played a pro-cyclical role. The rapid growth of credit has also led to a very sharp increase in the current account deficits, reaching double digits as a ratio of GDP in the Baltic countries and Bulgaria. For these reasons, Darvas and Szapáry (2008) argues that inflation targeting with floating exchange rates is better suited than fixed rates to manage the price level during the catching-up process while the price level gap is still large. They argued that the main risks for CEE countries with hard-peg derive from the fact that they do not have room to let the nominal exchange rate appreciate to accommodate the price level convergence.

After EU enlargement in 2004, there were several researches about the relationship between the exchange rate regimes and the macroeconomic performances of CEE countries. The macroeconomic performance of the "hard peg" and "floating" CEE countries over the period 1995-2006 is quite mixed (Arratibel and al 2008). While "hard-pegs" tended to experience faster real GDP growth than "floaters", they also tended to experience relatively larger external imbalances, especially during the last couple of years. More specifically, the findings suggest that, over this period, lower exchange rate volatility in the CEE countries was associated with higher growth (for relatively less financially developed economies), higher FDI inflows (for relatively more open economies), higher current account deficits, and a more volatile credit cycle. The limited date availability makes it impossible to firmly conclude on the direction of causality between exchange rate volatility and the above-mentioned variables.

There is considerable diversity in the exchange rate regimes of developing and transition countries, from very hard currency pegs to relatively free floats. Krawczyk (2004) discussed the dangers of entering in ERM II, which may result in a serious financial instability in the region; the author considered that countries should be allowed for varying monetary integration strategies as they have been adopting a variety of exchange rate regimes.

Shimizu (2009) suggests that, in normal times, for emerging countries, pegging their currency to a main neighbouring currency seems to be a good strategy to stabilize their economy. As the global financial crisis has happened, however, bond spreads became strongly affected by market volatility especially for hard pegging countries. It is due to a lack of flexibility of exchange rate, which could make country's economic management more difficult, and this might be regarded as bad news for market participants.

2 Is the exchange rate targeting in difficulty because of the effects of financial crisis?

The global economy was facing a worldwide financial crisis in 2008, but the impact of the financial crisis seemed to be different in each CEE country.

In the end of 2008 more challenging times have reached all Baltic countries. In the last quarter of 2008, the GDP change compared to the same period of the previous year was negative for all three countries (Lithuania -1,5%, Estonia -9,4%, and Latvia -10,5%), while it was the first quarter for Lithuania with negative growth since 1999. In 2009, GDP is expected to fall by 10% or more in all three countries. The unemployment level has increased, reaching 7,5% in Latvia (the highest in the Baltic countries), 6,2% in Estonia and 5,9% in Lithuania.

The economic situation is aggravated by the apparent lack of remedies. The labour markets are admirably flexible, statistics showing a rapidly decreasing wage growth. Still, the main trading partners (Sweden, Finland, Germany and Russia) are also in recession, and lower export prices are unlikely to provide benefits in the short term. Following the economic theory, an increased demand must come from domestic sources, but this option is largely unavailable to the Baltic countries. In spite of small fiscal deficits and public gross debt below 20% of GDP, it has become increasingly difficult for the governments to borrow from the financial markets.

In Estonia, Lithuania and Bulgaria, the monetary policy is conducted based on a strategy of targeting the exchange rate through currency board, helping to maintain long term price stability through the exchange rate and through reducing inflation expectations. On short-term, exchange rate macroeconomic instrument may not be a factor of inflation lowering; its influence might be seen rather over the current account deficits. The most important problem of these countries is losing monetary policy independence, which is put on "autopilot". Currency board is generally influenced by the decisions of the European Central Bank (ECB) and national banks in these countries can not use interest rate as an instrument of adjustment, because retail banking rates of interest are largely determined by foreign interest rates in euro area. However, transparency and rigidity of the currency board should theoretically increase the credibility of the nominal target of monetary policy in reducing inflationary expectations and thereby inducing a rapid convergence of inflation (especially if the anchoring is made on a strong currency). In reality, the Baltic countries with currency board faced in recent years the phenomenon of overheating, marked by inflationary pressures. Inflation gap between these countries and the Euro zone may be the consequence of a lack of credibility of the currency board or/and structural differences between the domestic economy and the anchor country.

Analyzing the economies of Baltic countries (Estonia and Lithuania), large increases in productivity (due to the process of real convergence with the advanced countries), in the conditions of a fixed exchange rate, generates a conflict between real and nominal convergence. The main cause is the so-called Balassa-Samuelson effect: significant increases in productivity in the “tradable” sector allow firms to raise wages without increasing export prices. These increases will reflect on the entire labour market, including in those sectors where productivity is low, generating high levels of inflation. Balassa-Samuelson effect is the most important factor that explains the "phenomenon of inflationary recovery" (catching-up inflation), characteristic of countries experiencing a process of real convergence, as it is the case of Baltic countries that have currency board regime.

In Estonia, inflationary pressure was relatively restrained by the real appreciation of the national currency, through the depreciation of U.S. dollar against the euro, given that many groups of products imported from Russia (the most important trading partner for this country) are valued in U.S. dollar. As a result of increased official interest rates of ECB, and taking into account the dependence of the Estonian financial system on the European financial markets, the monetary policy was more restrictive in the last period than in the previous years, although capital inflows raised and growth of monetary reserves has continued in 2007 and 2008.

Lithuania’s economic development in the period 2007-2008 has been driven by substantial increases in business investment (especially in early 2007), by a better absorption of EU funds and a rapid increase of income and consumption (supported by substantial loans). Domestic demand was the main engine of economic growth, private consumption being stimulated by an increased income. Moreover, increases in the prices of consumer goods have raised inflationary expectations, and thus encouraged the inclinations for consumption and not for saving. More efficient use of structural funds and improved financial situation of firms led the expansion of investment in construction. However, the high profitability of the activities related to the development of construction may cause an ineffective distribution of the economic potential growth on the long-term. In the crisis situation the most vulnerable sectors seems to be those who had a relatively high growth in the past, if their development is made in an unsustainable manner (e.g. more construction for population rather than for productive purposes).

The economic imbalances in Latvia have become more pronounced in the last years (2007-2008) and the external environment was also more complex, both contributing to changes of the monetary policy.

The Bank of Latvia continued to have a restricted monetary policy by increasing refinancing interest rates twice in 2007. The increasing refinancing rate had a double target: to protect the lats under a more expensive credit facility, thus increasing the cost of speculation, and to insist on excessive total demand reduction through an increased cost of credit. Widening the corridor of interest rates movement means an increase in macroeconomic risk in Latvia. Also, the ECB raised the basic interest rate twice during the year 2007, this situation taking effect on the financial sector and the cost of credit in Latvia.

Concerns over the stability of national currency in Latvia, in early 2007, have made a significant amount of lats to be converted into foreign currency. Meanwhile, the credit remained high, as well as inflation, while the risks of a “hard lending” of economic growth increased. Domestic demand has been reduced gradually due to a slowing in private consumption growth and in the gross fixed capital formation. Anti-inflationary plan adopted by the government had also a decreasing effect on domestic demand in Latvia.

Increased macroeconomic tensions, restricted conditions of lending, overheated housing market and the moderation of the economy restructuring, generated pessimistic forecasts for the next period (reduction in net exports, in private consumption and in investment activity). The crisis on the real estate market affects strongly Latvia’s economy especially that the developments in this sector have been fluctuating more than in the other Baltic States. Poor economic performance and increased credit costs have pushed prices further down on this market.

In Latvia, the signs of stagflation for the 2008-2009 are: slowing economic growth, reducing capital inflows, tightening credit conditions on the financial and monetary markets and the reassessment of the foreign capital enterprises’ risks.

In December 2008, after the economy slid into recession and after taking over its second largest bank (PAREX Bank), the government of Latvia had to seek the support of an IMF €7.5 billion bailout package (or about 35% of GDP), with a leading role for the IMF and support from the EU, Nordic countries, the World Bank and others. The 27-months IMF program is based on preserving the existing exchange rate within the narrow band and therefore requires exceptionally strong domestic adjustment policies, meant to support the rebalancing of the economy and recovery of growth prospects, and sizable external financing.

External deficit financing is the main target of the loans from foreign banks, because the Baltic States domestic banking sector is very attractive. Increased debt has been driven mainly by increased net liabilities of banks and other financial corporations to direct investors. In an environment where interest rates and the national gross debt are growing, the financing direct cost of the economic development through foreign capital flows (interest costs) is increasing, too.

In the last two years and in current crisis conditions, in the Baltic States and Bulgaria, increased tensions on the domestic and international market have induced at the level of investors’ behaviour a prudential assessment of investment risk. Rapid unsustainable economic development of these states resulted in increases of the domestic interest rates’ spread over those of ECB, generating inflationary pressure. In these circumstances, the currency board arrangements from Bulgaria, Estonia and Lithuania had and still have a very hard task in maintaining and improving macroeconomic stability.

3 Conclusions

NMS’ financial markets have been vulnerable to deteriorating investor sentiment, leading to significant pressure for exchange rate depreciation and/or a decline in foreign reserves or huge fluctuations in prices of equity and fixed-income instruments.

As a consequence of the current economic and financial crisis, the debate over euro-area enlargement needs to be seen in a new light. But it has not become any simpler. Although previous arguments against early adoption given the risk of creating boom and bust cycles remain valid, the attractiveness of joining the euro area has increased substantially for countries that rely heavily on capital inflows. Early euro-area entry is considered, lately, as a solution for external stability: being inside a large currency area helps considerably for small open economies in times of crisis.

A special case applies to those countries in fixed exchange-rate systems. These countries face a difficult choice now. An abandonment of the peg followed by sharp depreciation would have a devastating effect in the context of the large share of foreign-currency lending. If an adjustment in their real exchange rate is not possible, the reduction of current account deficits is unlikely to be achieved and probably will imply severe recession, especially because domestic prices and wages are not sufficiently flexible. An early entry into the euro area will not solve this macroeconomic dilemma.

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